United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

ORIGINAL

To be argued by:
Michael C. Devine

United States Court of Appeals

For the Second Circuit

UNITED STATES COURT OF APPEALS
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SECOND CIRCUIT

75-7108

PIERRE J. LELANDAIS & CO., INC., PIERRE J. LELANDAIS, RESEARCH & SCIENCE INVESTORS, INC., INTERCONTINENTAL TECHNOLOGY & NATIONAL RESOURCES, CORONET FUND and CREATIVE CAPITAL FUND,

Plaintiffs-Appellees;
Cross-Appellants;

vs.

MDS-ATRON, INC. and MOHAWK DATA SCIENCES CORP.,

Defendants-Appellants,

and

JOSEPH S. STOUTENBURGH and RICHARD L. KARPEN,

Defendants.

On Appeal from the United States District Court

For the Southern District of New York

BRIEF OF PLAINTIFFS (APPELLEES AND CROSS-APPELLANTS)

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COUNTER-STATEMENT OF ISSUES PRESENTED FOR REVIEW

A. As to the main appeal:

1. The district court found the undisclosed information concerning Mohawk accounting changes to be material. Was that finding clearly erroneous?

2. Did the district court err in concluding that under sections 10(b) and 14(a) of the 1934 Act reliance is not an element of plaintiffs' causes of action based upon material omissions and non-disclosures?

3. Was the district court's formulation of damages clearly erroneous?

B. As to the cross-appeals:

1. Must every plaintiff prove, as an indispensable element of its case under sections 10(b) and 14(a) of the 1934 Act, that it voted in favor of the corporate action to which the false and misleading proxy solicitation pertained? The district court so concluded with respect to ITNR. Was that conclusion erroneous?

2. Did the district court err in dismissing the "free stock" deception portion of plaintiffs' case?

COUNTER-STATEMENT OF THE CASE

1. Nature of the case. This is a private action for damages under the Securities Exchange Act of 1934 ("1934 Act"; 15 U.S.C. §78a et seq.), more specifically under sections 10(b) and 14(a), as well as the rules of the Securities and Exchange Commission promulgated thereunder. The six plaintiffs were shareholders of Atron Corporation ("Atron"), which was merged into MDS-Atron, Inc., a subsidiary of Mohawk Data Sciences Corp. ("Mohawk"), on April 30, 1971. The defendants are Mohawk, MDS-Atron, and two individuals, former directors of Atron.

2. Course of proceedings. This action was tried in the Southern District of New York, to Honorable Charles L. Brieant, Jr., sitting without a jury.

3. Disposition below. The district court dismissed the complaint of one plaintiff, Intercontinental Technology & Natural Resources, S.A. ("ITNR"), as to all defendants. It dismissed the complaint of all other plaintiffs as to the two individual defendants.

The district court granted a money damage judgment for all plaintiffs, except ITNR, against MDS-Atron and Mohawk. (971a-972a).

MDS-Atron and Mohawk (defendant-appellants) appeal

from the judgment against them. ITNR cross-appeals from the dismissal of its complaint, and the remaining plaintiffs cross-appeal from so much of the district court's decision as denied their claims based upon the so-called "free-stock" deception.

4. Statement of the facts. Plaintiffs acquired their Atron stock directly from Atron, in private transactions in 1968 and 1969. (51a-54a). Their stock was subject to restrictions on transfer, designed to prevent violation of the Securities Act of 1933. Atron stock of other shareholders, not so restricted, was traded in the over-the-counter market. (63a).

In January, 1971, Mohawk and Atron agreed in principle on a merger, with the exchange ratio to be one share of Mohawk for four shares of Atron. The formal merger agreement was signed on March 12, 1971. (60a).

On April 16, 1971, Atron issued a notice of a special meeting of shareholders to be held on April 30, 1971, for the purpose of voting on the proposed merger. The notice was accompanied by a proxy statement, by which Atron management solicited votes in favor of the merger. (60a-61a; 549a-598a).

All of the plaintiffs received and read the proxy statement prior to submitting their proxies. (87a-88a;

218a-219a; 258a-259a; 693a; 697a). With the exception of ITNR, all plaintiffs voted in favor of the merger. (51a-54a).

At the special meeting of shareholders on April 30, 1971, the merger was approved -- by a vote of 924,756 shares in favor (99.7%), and 3,600 shares against (0.3%). (61a).

On the second business day following the vote on the merger, May 4, 1971 (April 30, 1971, was a Friday), Mohawk issued a press release announcing significant events bearing upon Mohawk's business and its past financial performance. (651a-653a). The matters revealed by the press release had not been disclosed to Atron shareholders prior to the vote on the merger the preceding Friday.

These matters (which the district court referred to as the "accounting change" deception) are described more fully in the argument portion of this brief. However, primary among the undisclosed facts was Mohawk's decision to change its method of accounting for so-called "third-party" sales.

Mohawk's business was the manufacture and sale (or lease) of computer equipment. (50a). It referred to transactions of the following type as "third-party" sales.

Mohawk leased computer equipment to an end-user, normally for a stated term of five-years, although the lease was cancellable at the will of the lessee. Thereafter Mohawk sold the equipment, while subject to the lease, to a "third-party", a financing company. Mohawk collected the rent for the "third-party", but it was obligated to pay the full rent whether or not it collected from the lessee. Mohawk thus acted as a rent guarantor. In addition, if the lessee, by reason of default or cancellation, returned the equipment, Mohawk was obligated to continue rent payments to the "third-party" or substitute another piece of equipment which was subject to an effective lease.(120a-131a; 611a).

During fiscal 1970 (August 1, 1969, through July 31, 1970) and the first six months of fiscal 1971 (August 1, 1970, through January 31, 1971) Mohawk accounted for such "third-party" sales by taking into income immediately the full amount which the financing company agreed to pay for the equipment. (131a-133a). Initially, in fiscal 1970, the financing company paid Mohawk the full "sales" price at the time the transaction was agreed upon. Later, in fiscal 1971, part of the price was withheld by the financing company and paid to Mohawk in later installments. (138a-139a).

In early 1971 the propriety of Mohawk's method of accounting for "third-party" sales was questioned, in discussions involving top management and the outside auditors. (139a-145a). Professional doubt about the method in general was exacerbated at Mohawk by two factors -- the installment method by which Mohawk received the "sales" price, and the unexpectedly high rate of lease terminations. (134a-145a; 611a).

As a result, Mohawk changed to a method of accounting whereby income was reported when equipment rents accrued rather than upon "third-party" sales. (138a). The change first was announced in the May 4, 1971, press release. It was retroactive, and when its effect was combined with other extraordinary items, the following downward adjustment or restatement of Mohawk's net income figures for fiscal 1970 and 1971 resulted: (562a; 609a; 663a)

	Unadjusted		Adjusted or restated	
	Net income	Net income per share	Net income	Net income per share
1970	$8,323,000	$1.52	$5,808,000	$1.02*
1971	$3,560,400**	$ .26	($1,050,000)	($ .18).

Other proxy statement misrepresentations and omissions relating to the "accounting change" deception

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* Apparently $.23 of this $.50 adjustment is related to matters other than the method of accounting for "third-party" sales. The "pooling of interests" with Atron was one such other matter.

** Assuming 48% tax rate.

are enumerated in the succeeding arguments, as are the facts relevant to the "free stock" deception.

5. Summary of argument. Argumentative points I, II, and III constitute appellees' brief in opposition to the main appeal. Points IV and V constitute plaintiffs' brief in support of the cross-appeals.

POINT I

AS A RESULT OF THE UNLAWFUL ACTS OF ATRON AND MOHAWK PLAINTIFFS SUSTAINED ACTUAL, COMPENSATORY DAMAGES IN AN AMOUNT NOT LESS THAN THAT AWARDED BY THE DISTRICT COURT

A. The applicable general principles. Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386-389 (1970) recognizes that in private damage actions under the federal securities laws the trial court, as a court of equity, has discretion and flexibility in fashioning remedies which effect the congressional purpose. At the same time, Mills directs that "damages should be recoverable only to the extent that they can be shown" (p.389), keeping in mind that uncertainties inherent in computing damages must be resolved against defendants. Chris-Craft Industries, Inc. v. Piper Aircraft Corp., ____ F.2d _____ (2d Cir. 1975); Fed. Sec. L. Rep. ¶95,058 (at p.97,706), ("Chris-Craft III"), referring to Chris-Craft Industries, Inc. v. Piper Aircraft Corp., 480 F. 2d 341, 375 (2d Cir. 1973), cert. denied, 414 U.S. 910 (1973) ("Chris-Craft II") and Mills, supra. Within these guidelines the Second Circuit has held that both compensatory and consequential damages can be "shown", and that defendants may be ordered to disgorge profits. Zeller v. Bogue Electric Mfg. Corp., 476 F. 2d 795 (2d Cir. 1973), cert. denied, 414 U.S. 908 (1973).

B. <u>The formulation of damages urged by plaintiffs in the instant case</u>. In the district court plaintiffs sought, and were awarded, compensatory damages only. (957a). Compensatory damages may be computed in different ways. The so-called "out-of-pocket" measure has been employed in some cases. <u>Levine v. Seilon, Inc.</u>, 439 F. 2d 328, 334 (2d Cir. 1971). There is also the realized loss approach of <u>Chasins v. Smith, Barney & Co.</u>, 438 F. 2d 1167 (2d Cir. 1970).**

In the instant case plaintiffs urged application of one of the remedies suggested by the Supreme Court in <u>Mills</u>; namely, that they "receive the value that was represented as coming to them." (<u>Mills</u>, <u>supra</u>, at p.388). The proxy statement represented that the Atron shareholders would receive one share of Mohawk stock for every four shares of Atron. At the moment that the Atron shareholders voted in favor of the merger, in reliance upon the 4-to-1 exchange ratio, Mohawk stock sold for $44.62 per share.* Thus it was represented to plaintiffs, and all

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* The exact price of Mohawk stock on April 30, 1971 ($44.62) is easily established -- that is the amount which Mohawk paid in lieu of issuing fractional shares of Mohawk stock in exchange for Atron holdings not divisible by four. (76a).

** As noted in <u>Chasins</u> (at p.1173), the "out-of-pocket" rule is not appropriate in cases where the damage is not related solely to the price of the transaction, but also to the <u>fact</u> of the transaction -- the unlawful inducement. The present case is of the latter variety, i.e., within the <u>Chasins</u> rule.

other Atron shareholders, that they had $11.15 in Mohawk stock "coming to them" for every share of Atron stock.

They did not get that which was represented as coming to them. By the time plaintiffs were permitted to sell their Mohawk stock its price had decreased substantially, causing plaintiffs to sustain the following damages:

Plaintiff (number of Mohawk shares)	Represented value of Mohawk stock (at $44.[illegible])	Minus Proceeds of later sale of Mohawk stock	Damage
LeLandais (1583 shares)	$ 70,048	$43,520	$ 26,528
Coronet Fund (5312 shares)	235,056	5,970*	229,086
Creative Capital Fund (4,062 shares)	179,744	60,459	119,285
RSI (2500 shares)	110,625	41,260	69,365
ITNR (1250 shares)	55,313	-0-*	55,313
			$499,577.

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* Coronet Fund sold 312 of its Mohawk shares. It still owns 5,000 shares. ITNR has not sold any Mohawk stock. It still owns 1250 shares. Therefore, with respect to these plaintiffs the recovery sought was rescissional in nature; that is, they would return their current holdings of Mohawk stock to the defendants in exchange for payment of the market price of their stock at the time of the merger. Swanson v. American Consumers Industries, Inc., 475 F. 2d 516, 521 (7th Cir. 1973). As to the expansive manner in which the district court should employ its equitable powers in devising rescissional remedies, see Gordon v. Burr, 506 F. 2d 1080, 1083 (2d Cir. 1974).

C. The district court's formulation of damages. In essence the district court adopted the Chasins, supra approach to damages; that is, it determined the value of plaintiffs' Atron stock on the day of the merger (the purchase price of the Mohawk stock) and subtracted the amounts received by plaintiffs upon subsequent sales of their Mohawk stock. This remedy is rescissional in nature, and is consistent with Swanson v. American Consumers Industries, Inc., 475 F. 2d 516, 520-521 (7th Cir. 1973), where plaintiffs were awarded (as damages) the value of the stock they surrendered in the corporate reorganization,* although it was found that at the time of the reorganization the stock which they had received had been equal in value to that which they had surrendered. Strict application of this formula in the instant case would have produced damage awards the same as those sought by plaintiffs. However, the district court made two modifications which significantly reduced the awards.

First, it did not accept the market price of Atron stock on the day of the merger as a true measure of what plaintiffs paid for their Mohawk stock. Instead,

* Plaintiffs of course were required to tender back the stock of the acquiring corporation.

the court selected the market price on March 12, 1971 (7 weeks prior to the merger) as a truer measure. It was as of March 12, 1971, that the merger agreement was signed, and the court found that thereafter the market price of Atron stock was affected by the price of Mohawk stock; in other words, that the rise in the price of Atron stock between March 12, 1971, and April 30, 1971, was caused to some degree by a rise in the price of Mohawk stock. Of course it is conceivable that during this period the market price of Atron stock would have risen faster (relatively) than the price of Mohawk stock, and that the Mohawk price acted as a ceiling on Atron's appreciation. The district court did not discuss this possibility, and the appellants seek to belittle it by arguing that Atron's stock was overpriced in view of its allegedly desperate business condition.

Atron's business condition was not desperate. In 1971 the company was young, having commenced operations in early 1969. Therefore its financial performance was expectably unprofitable. Such is normal for start-up companies.

Atron was managed by a group of men known in the industry to be highly expert in their field, and it had a remarkably strong balance sheet, with more than $3,100,000

in cash, total liabilities of $304,371, and a net shareholders' equity of $4,296,940. (582a - 588a). Atron's progress and prospects were recognized by the investing public which purchased Atron securities in the January, 1970, public offering. Thereafter Atron's sales grew rapidly. In the three months which had ended December 31, 1969, Atron had net sales and service income of $120,307, on which a loss of $247,944 had been sustained. By comparison, in the three months ended December 31, 1970, Atron had net sales and service income of $637,544, on which a loss of $146,155 was sustained. Thus in one year Atron had increased operating income by 500% ($500,000), and cut its loss by 40% ($100,000). The continuation of this trend would have been aided by the phasing out of expenses related to developmental cost.* Atron's steady improvement in its formative years was accomplished in the face of a recessive business climate, which had a direct impact on the computer industry.

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* Defendants' allegations (e.g., brief, pp.6, 27) that Atron was sustaining operating losses at the rate of $200,000 per month is a misrepresentation. The trial transcript references are to "expenditures" at that rate, not losses. Defendants' statements also are belied by the above-mentioned loss of only $146,155 for the three months ended December 31, 1970, an average of less $49,000 per month.

The public market price of Atron stock had fallen in mid-1970, but was climbing back during late 1970 and early 1971. On January 28, 1971, prior to any mention of a Mohawk merger, the market price of Atron stock was $7.75 per share. On the same day Mohawk stock sold at $29 per share. Thus an investor could have purchased a share of Mohawk with less than four shares of Atron. Yet in the merger a full four shares of Atron was required to obtain one share of Mohawk.

It is understandable that Ladenburg, Thalman, Atron's investment banker and underwriter, reacted so immediately, and so negatively, to the first announcement of the merger agreement. They believed that the exchange ratio was unfair to Atron shareholders. (307a).

Thus it is probable that from January, 1971, through April, 1971, the market price of Atron's stock would have continued its increase, and well may have exceeded Mohawk's appreciation had it not been for the restraint of the merger prospect. (Trial record 440-442).

Therefore, the district court should have accepted the market price of Atron's stock on April 30, 1971, as a minimum measure of what plaintiffs paid for their Mohawk stock. This is precisely the result directed by the Seventh Circuit in Swanson, supra. There the court held that plaintiffs were entitled to damages

reflecting the appraisal value of their stock in the company being acquired, which it determined solely by reference to the value attributed to that stock in the reorganization plan. In the instant case, the value attributed to the Atron stock in the merger was one-fourth of $44.62 (the price of Mohawk), or $11.15 per share, which is $2.55 per share more than the district court awarded.

The second modification which the district court made in the damage formulation urged by plaintiffs was the imposition of a duty to mitigate damages, holding that plaintiffs were obligated to sell their Mohawk stock within the first thirty days after that stock first was registered with the SEC. Only one of the plaintiffs, LeLandais, actually sold during that thirty day period. The price of Mohawk stock continued to fall after the thirty days, and therefore the mitigation requirement imposed by the district court had the effect of reducing the damage award for every plaintiff except LeLandais.

Thus in the district court plaintiffs sought damages totaling $499,577,* and the court awarded $164,431.

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* Again, subject to Coronet Fund and ITNR returning to Mohawk the Mohawk stock which they still own (6250 shares).

In light of the discretion which the district court, as a court of equity, possesses in assessing damages, it is difficult to say that the award in this case is clearly erroneous. Swanson, supra, at p.519. However, plaintiffs urge that their actual damages exceed those awarded.

D. Defendant-appellants' arguments as to damages. Mohawk and MDS-Atron contend that plaintiffs should be treated as if they had dissented from the merger and been relegated to their statutory appraisal rights. Further they contend that in an appraisal proceeding plaintiffs' Atron stock would have been valued at less than the value of the Mohawk stock which they received. This conclusion is based upon a highly speculative foray into what Minnesota state law might be (no Minnesota authority is recited), as well as some equally speculative assumptions as to how Minnesota appraisal proceedings might have turned out.

Although in some instances, such as Swanson, supra, it may be appropriate in fashioning a damage formula to consider appraisal rights which shareholders have lost, this does not mean that the court must conduct such a proceeding under conditions resembling these which might pertain in the state court. Here plaintiffs did not dissent from the merger, and they have not prosecuted this action for the purpose of enforcing the

state law appraisal remedy; rather their purpose has been to demonstrate fraud within the meaning of the federal securities laws and to recover compensatory damages determined in accordance with the general principles of Mills, Chasins, Chris-Craft III, Swanson, and the other federal authority discussed herein. To the extent that any consideration of lost appraisal rights is appropriate, it is the Swanson method of determination which should be adopted; i.e., the value of those lost rights is equivalent to the value attributed to the stock surrendered in the merger. Of course this holding in Swanson, in net effect is comparable to, and precedent for, the district court's conclusion in the instant case that defendants are estopped from denying that Atron stock was worth what Mohawk agreed to pay for it; namely, one-quarter share of its own stock.

Defendants also argue that the district court erred in selecting March 12, 1971, as the date for determination of the value of the Atron stock surrendered by plaintiffs. Their argument is that Mohawk had accepted the 4-to-1 exchange ratio earlier (on March 2, 1971, at a board of directors meeting), and therefore the dating of the merger agreement as of March 12, 1971, did not mean that on March 12, 1971, Mohawk believed Atron stock to be worth $8.60 per share (one-fourth of Mohawk stock's

price on that date). This type of argument not only fails to demonstrate "clear error", but also misconstrues the record. The district court seemed to be posing the following question: when prior to April 30, 1971, did Mohawk last affirm the 4-to-1 exchange ratio; that is, when did it finally and effectively commit itself to go ahead with the merger at that ratio? The record shows that Mohawk could have disaffirmed the whole merger as late as April 21, 1971, but chose not to. Under paragraph V(1)(a) of the merger agreement Mohawk's consent, in its capacity as the sole shareholder of MDS-Atron, was a pre-condition to the merger. It did not give that consent until April 21, 1971. (532a). On that day Mohawk's stock last traded at $40.12, indicating Mohawk's belief, nine days before the merger, that Atron stock was worth more than $10 per share.

In sum, the district court computed plaintiffs' damages in a restrictive fashion, producing a modest award, without attorneys fees. Defendants' attempts to further reduce the award are not supported by case authority, are inconsistent with the congressional purpose, and misconstrue the record.

POINT II

THE DISTRICT COURT WAS CORRECT IN FINDING THAT THE "ACCOUNTING CHANGE" OMISSIONS WERE MATERIAL

On this appeal defendants attempt to divide "a hair 'twixt south, and south-west side." Republic Technology Fund, Inc. v. Lionel Corp., 483 F.2d 540, 551 n.11 (2d Cir. 1973), cert. denied 415 U.S. 918 (1974). They allege that the district court erred in finding the "accounting change" non-disclosures material because it framed the finding in terms of "might" rather than "would".

Admittedly there is some scholarly uncertainty as to the proper wording of the materiality test in actions under §14(a) of the 1934 Act. The Supreme Court, in Mills, supra, held that a fact was material if it "might have been considered important by a reasonable shareholder who was in the process of deciding how to vote." (p.384). However, the Second Circuit has held that a "slightly higher standard" is "more appropriate", and has substituted "would" for "might" in the Supreme Court's formulation. Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1302 (2d Cir. 1973).*

In the instant case the district court apparently adopted the Supreme Court's phraseology, and although

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* The Seventh Circuit recently has rejected the "would" test and adhered to the Supreme Court's "might" test. Northway, Inc. v. TSC Industries, Inc., 512 F.2d 324 (7th Cir. 1975).

it is an interesting question whether the Supreme Court ultimately will alter its phraseology in light of Second Circuit holdings, it is not the question here. The omissions in the Akron proxy statement were material both in the "might" sense and in the "would" sense, as is clear from the district court opinion read as a whole.* In <u>Gerstle</u> Judge Friendly observed that the "might-would" question "is obviously of more importance when a judge must instruct a jury than when, as here, the case is tried to him." (n.22, p. 1302).

The district court correctly found that the proxy statement failed to disclose at least the following material facts:

(1) Prior to April 16, 1971, Mohawk management and its accountants knew that Mohawk's accounting treatment of "third-party" sales of leased equipment had become subject to professional criticism. (949a).

(2) Prior to April 16, 1971, Mohawk had had discussions about changing its accounting practices regarding "third-party" sales of leased equipment. (949a).

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* Clearly the district court found that the undisclosed facts concerning "accounting changes" <u>would</u> have been important, not that they <u>might</u> have been important. The court's decisiveness in this regard is best evidenced by its finding that this one claim was so "clear cut" that it was inappropriate for plaintiffs' counsel to introduce a second claim into the same case. Attorneys fees were denied for this reason. (963a). This is not a mark of uncertainty as to materiality.

(3) Prior to April 30, 1971, Mohawk had changed its fiscal year from a July 31 end to an April 30 end, causing the 1971 fiscal year to be 9-months in length, ending on the same day as the vote on the Atron merger. (950a, 952).

(4) Premature terminations of leases which had been the subject of third-party sales had exceeded Mohawk's original expectations by a substantial amount. (951a).

(5) Certain third-party transactions had not provided the entire sales proceeds in immediate cash for Mohawk.* (951a).

(6) Among the several reasons for the change in Mohawk's fiscal year was a desire to apply a "cosmetic treatment" to adverse earnings for the current period. (952a).

(7) In March, 1971, Mohawk management had decided that commencing May 1, 1971 (the day after the vote on the Atron merger) Mohawk would discontinue its practice of "third-party" sales. (953a).

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* Judge Brieant correctly noted that Mohawk reported "these sales as instant earnings, although not receiving the cash flow which the casual reader of a financial statement would associate with the amount of dollars in sales booked during the period." (951a).

(8) Not later than April 24, 1971, Mohawk's independent certified public accountants had approved and recommended the change in Mohawk's accounting practices regarding "third-party" sales of leased equipment. (953a).

(9) Mohawk was going to make miscellaneous adjustments in its financial statements for fiscal 1971, which would have the effect of reducing net income substantially. (954a).

The district court found specifically that certain of these undisclosed facts, standing alone, would have been sufficiently material to conclude that the proxy statement was unlawfully misleading. (951a). However, it is upon the combined significance of these facts that the sufficiency of the proxy statement must be determined, and the district court held that "all considered together" they "were material". (954a).

The strategy of appellants' brief is to select a few of the omissions, ignoring the others, and then to assert that the selected omissions, examined in isolation, out of the full factual context, were immaterial.

Considered together, the omitted facts demonstrate that in the months immediately preceding the Atron merger Mohawk's management had decided that, effective April 30, 1971, it would effect a significant series of business

changes and accounting adjustments; including cessation of its primary financing practice ("third-party" sales); revision of the method of accounting for this practice, including significant downward restatement of past earnings figures; change of the fiscal year, and shortening of the 1971 fiscal year; introduction of a major new product; and finally, adoption of a series of miscellaneous accounting adjustments which would further reduce 1971 net income. Thus April 30, 1971, had been selected by Mohawk as the effective date for significant changes in Mohawk's business direction and accounting methods. April 30, 1971, also was the date of the Atron merger, yet in the proxy statement there was not a hint of disclosure of this redirection, much less the full and fair disclosure mandated by the federal securities laws.

The most striking omission from the proxy statement is the non-disclosure of the impact which the accounting changes would have on Mohawk's net income for fiscal 1970 and 1971; namely, a per share reduction for fiscal 1970 of $.27, from $1.29 (565a) to $1.02 (609a), a 20% reduction.* For fiscal 1971 Mohawk had reported (in the

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* As the district court correctly observed (954a), the restatement caused a total change in 1970 net income of $.50 per share (compare 562a with 609a); however, $.23 of the change appears to have resulted from adjustments other than in the method of accounting for "third-party" sales.

proxy statement; 563a) 6-month net income of $.43 per share, and then following the accounting change reported a loss of $.18 per share for the 9-month period (609a). In the absence of accounting changes and miscellaneous adjustments Mohawk's income before taxes for fiscal 1971 would have been $5,230,000 higher. (663a). Assuming a 48% tax impact, net income would have been $2,510,400 higher, changing a per share loss of $.18 per share into a profit of $.26 per share. Of this $.44 differential approximately $.11 was due solely to the change in the method of accounting for "third-party" sales. (663a). In percentage terms, the accounting changes and adjustments reduced net income per share almost 170%.

Appellants argue that Mohawk did not know even the approximate magnitude of these income reductions until after April 30, 1971. Not only is this incredible on its face, but it is belied by Mr. Wells' interview with the Wall Street Journal on May 3, 1971, the first business day following the merger. Reputedly without the benefit of any preliminary estimates by Mohawk's accounting personnel, Mr. Wells was able to forecast for the interviewer the ultimate dollar impact of the accounting changes. His forecast turned out to be exact. He said 10 to 12 cents per share. The impact was 11 cents per share. (182a-184a; 663a). Certainly, with the assistance

of Mohawk's internal personnel and its outside auditors, Mr. Wells could have made a reliable approximation, or even an exact calculation, a few days earlier, for the enlightenment of the Atron shareholders.

In Republic Technology, supra, this Court said:

> Where a merger is in prospect, the earnings picture of the acquiring corporation has to be of real significance to the stockholders of the corporation proposed to be acquired, and the most current earnings are of the highest importance. See Kaiser-Frazer Corp. v. Otis, supra. Accordingly, failure to convey these earnings accurately, if the discrepancy is at all substantial, has to be material to the person being misled. (at p.551).

Defendants also argue that the decision to change methods of accounting was made after April 30, 1971 (brief, p.49). Even if that were so, disclosure of consideration of the change would have been required. Republic Technology, supra, at p.547. But it is not so. The change had been decided upon, as the district court correctly found. In addition to the evidentiary support for this finding specified in the decision below, reference should be had to Mohawk's registration statement filed with the SEC in August, 1971. Mohawk therein states unequivocally that it "retroactively changed its accounting policy during fiscal 1971" (emphasis added); namely, prior to April 30, 1971. (511a).

Similarly, defendants claim that disclosure of the change in Mohawk's fiscal year would not have been meaningful. This argument defies common experience. Shortening of the fiscal year normally is associated with a period of significantly reduced earnings. The district court correctly found such an association in the present case. Mohawk's decision to shorten its 1971 fiscal year was made in March, 1971. February, March, and April, 1971, were three of the worst months in Mohawk's history.

In the immediately preceding six months, Mohawk had average monthly revenues of $7,514,000, average monthly expenses of $6,763,000,* and thus an average monthly profit (before taxes) of $751,600.* In the next three months (February, March, and April, 1971) there was an incredible, overnight deterioration. Average monthly revenues were $7,602,000 (no significant change), but average monthly expenses soared to $7,862,000 (an increase of over $1,000,000 per month), and profits turned into average monthly losses of $260,000.** These figures do <u>not</u> include the extraordinary changes and adjustments; this was a purely operational deterioration.

Announcement of the shortening of Mohawk's 1971 fiscal year would have forewarned Atron shareholders of a negative earnings report, although nothing this severe would have been suspected.

* Assuming 48 percent tax impact for interpolation purposes.

** These figures can be interpolated from a comparison of 563a with 663a. In order to make the comparison meaningful, the extraordinary changes and adjustments have been eliminated from the figures.

Finally, defendants argue that the impact of the accounting changes and adjustments was insignificant.* This obviously is not so. The reasonable Atron shareholder would have found it important to know that Mohawk's net income for fiscal 1970 had been overstated by 20%, and that its net income for fiscal 1971 would be adjusted, and restated downward, by $.44 per share (after taxes), altering its performance for the year from a $.26 profit to an $.18 loss.

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* Mohawk effectively dismembered full disclosure of the accounting changes and adjustments by releasing pieces of information, of increasing specificity, gradually between May 3, 1971, and August 23, 1971. In all likelihood this procedure accounts for the gradual, rather than precipitous, decline in the price of Mohawk stock during this period. Of course the stock did drop 5 points between the July 6, 1971, close and the July 8, 1971, close, when Mohawk first announced the detailed, dollar impact of the changes, on July 7, 1971.

POINT III

RELIANCE IS NOT AN ELEMENT OF PLAINTIFFS' CAUSES OF ACTION

Plaintiffs need not prove "reliance" as part of their cause of action based on §14(a) of the 1934 Act. This is true as to both express misrepresentations and omissions. With respect to plaintiffs' cause of action based on §10(b) of the 1934 Act, reliance need not be proved as to omissions.

In Cohen v. Franchard Corp., 478 F.2d 115, 124 (n.12) (2d Cir. 1973), cert. denied, 414 U.S. 857 (1973), this Court said:

> In Mills v. Electric Auto-Lite Co., 396 U.S. 375, 385 (1970) (Section 14(a)), and Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972) (Rule 10b-5), the Supreme Court held that, under the circumstances of those two cases, it was unnecessary to prove actual reliance. It was enough that there were material misrepresentations in solicitation documents which were "an essential link in the accomplishment of the transaction" 396 U.S. at 385.

Also, Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228 (2d Cir. 1974).

Thus Mills held that reliance is not an element of plaintiffs' §14(a) cause of action; but it went further, it also held that causation (an element more general than reliance) need not be proved if two other facts are established: (1) that the proxy statement was materially false

or misleading, and (2) that the proxy solicitation was an essential link in the transaction. Both of these facts were proved in the present case, and the district court so held. Therefore the inquiry with regard to reliance and the §14(a) cause of action need go no further.

In the instant case plaintiffs also allege a §10(b) violation based upon express misrepresentations, and to that limited extent reliance may be relevant. The district court did not reach this issue because it found the proxy statement omissions an adequate ground for decision.

Nevertheless, actual reliance was proved. All of the plaintiffs testified that they received and read the proxy statement (LePow (Creative Capital Fund) 87a-88a; Ludt (Coronet Fund) 693a, 697a; Wertheim (RSI; ITNR) 218a-219a; and LeLandais 258a-259a).

Appellants argue that reliance is disproved if plaintiffs intended to sell their Mohawk stock following the merger, rather than hold it for longer run appreciation. In that case, the argument goes, plaintiffs would not have been concerned with Mohawk's business or financial performance, and would have voted for the merger even if they had known the truth about those subjects.

This of course is not so. Whether the primary

goal is long-term investment or short-term gain an investor always wants to know information which may cause a change in the market price of the security. In the present case the plaintiffs relied upon the proxy statement representations concerning Mohawk for at least three reasons: (1) to determine the fairness of the exchange ratio; (2) to determine likely short-term price movements of Mohawk's stock, and (3) to determine the likely long-term price trend of Mohawk's stock. Although the plaintiffs may have placed less emphasis on the third reason than on the others it does not follow that they totally disregarded all proxy statement representations concerning Mohawk's business and financial performance.

In all likelihood if plaintiffs had known of the undisclosed information they would have voted "no" on the merger and demanded their appraisal rights. This would have been somewhat comparable to a short-term sale of the Mohawk stock received in the merger, assuming that the proxy statement had been complete and truthful.

Of course this is all speculative. Plaintiffs read and relied upon the proxy statement, and, to the extent that reliance is an element in their §10(b) misrepresentation cause of action, they need not prove what they would have done had the proxy statement been other than it

was.* Mills specifically rejects the need for any such proof, holding that a material nondisclosure thwarts "the informed decision at which the statute aims, regardless of whether the terms of the merger were such that a reasonable shareholder would have approved the transaction after more careful analysis." (at p.384, n.6).

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* Messrs. LePow and Wertheim indicated uncertainty as to what they would have done had the proxy statement been true and complete simply because there are so many variables in that assumption that accurate forecasting is difficult.

POINT IV

THE DISTRICT COURT ERRED IN BARRING RECOVERY BY ITNR

The judgment below dismisses the complaint as to one of the plaintiffs -- ITNR. The sole reason for the dismissal was ITNR's failure to vote with respect to the merger. (962a). In other words, the district court held that in order to recover damages under §14(a) of the 1934 Act the shareholder-plaintiff must prove that he voted in favor of the corporate action (merger, in this case) which is effected in conjunction with the false and misleading proxy statement.

The imposition of such a pre-condition to recovery is unprecedented. It also is inconsistent with the primary purpose of the federal securities laws, which, in this context, is to compensate the public shareholder for damage resulting from use of a false and misleading proxy statement. The merger of Atron into MDS-Atron caused ITNR to exchange Atron stock for Mohawk stock, which thereafter suffered a substantial decline in price. As a matter of law, the merger was caused by the materially false and misleading proxy statement. Thus the chain of causation from the unlawful act (the proxy statement) to ITNR's damage is direct and unbroken. The

fact of damage, and the causation of that damage, are in every way the same for ITNR as they are for those plaintiffs who voted in favor of the merger.

The law does not require the performance of futile or meaningless acts. ITNR's vote in favor of the merger would have been a meaningless act in that it simply would have increased the percentage voting in favor of the merger from 99.7% to 99.7+%. In Swanson, supra, plaintiffs' votes were meaningless because the acquiring corporation owned 87% of the outstanding stock of the corporation being acquired. Nevertheless, the court directed a damage award.

In the instant case the fallacy in the district court's reasoning is best illustrated by positing the situation where a particular shareholder has full knowledge of the falsity of the proxy statement prior to the merger. If, in such a case, the necessary percentage of shareholders are deceived by the proxy statement, the undeceived shareholder is damaged nonetheless, and to the same proportionate extent as other shareholders. This is true even if the undeceived shareholder votes "no" or refuses to vote. His damage is an inevitable side-effect of "majority rule", and is caused by the false proxy statement. He may not control his fate even though he

knows of the deception.

This is precisely what occurred in Schlick v. Penn-Dixie Cement Corp., 507 F. 2d 374 (2d Cir. 1974). There the plaintiff was aware of the proxy statement deficiencies even before the merger had been finalized. Indeed he instituted his damage action prior to the merger. No injunction was sought. Nevertheless, plaintiff's right to sue for damages was sustained. Certainly Mr. Schlick did not vote in favor of the merger.

Similarly, in **Mills**, supra, the plaintiff-shareholder sought to enjoin the shareholders' meeting at which the merger was approved. He prosecuted his suit for damages only after his injunctive efforts failed. It therefore is apparent (although not discussed in the decision) that the plaintiff had not voted in favor of the merger. The Supreme Court did not find this fact disabling. Quite to the contrary, the essential reasoning of Mills is that plaintiff need not prove that his vote was affected, or even how many votes were affected; he need only prove that the proxy solicitation itself was an essential link in accomplishment of the transaction (p.385).

Finally, ITNR's failure to vote with respect to the merger in the instant case was not a purposeful omission; rather it was an administrative failure of communication. Another of the plaintiffs, RSI, acted as

ITNR's investment adviser, and in voting its own Atron stock RSI voted in favor of the merger. (52a, 222a, 228a). However, in the case of ITNR the decision-approval procedure and the physical handling of the proxy went awry. The result was failure to submit the proxy in timely fashion.

In short, the position of ITNR is in all respects the same as that of every other plaintiff, except that, due to administrative error, its merger vote (which could not have affected the outcome) was not registered.

POINT V

THE PROXY STATEMENT WAS MISLEADING IN THAT IT DID NOT DISCLOSE THAT MORE THAN 65% OF THE MOHAWK STOCK TO BE ISSUED IN THE MERGER WOULD BE UNREGISTERED AND RESTRICTED

As previously stated, plaintiffs were misled in two distinct respects, one referred to as the "accounting change" deception (discussed above), and the other referred to as the "free stock" deception.

Some 71% of the Atron stock outstanding on April 30, 1971, the date of the merger, was legended and its transfer restricted. This included all of plaintiffs' stock. (54a). The proxy statement contained statements which led certain of the plaintiffs to believe that in the merger Mohawk would issue unrestricted stock to all Atron shareholders. (259a-260a; 696a-697a). In addition, Mr. LeLandais, in a conversation with Atron's president, was led to believe that holders of restricted Atron stock would receive unrestricted Mohawk stock. (258a; 263a-264a). The proxy statement did not make any express statements on this question. On May 26, 1971, shortly after the merger had been approved by Atron's shareholders, Mohawk issued a letter which for the first time disclosed that persons holding restricted Atron stock would receive restricted

Mohawk stock. (601a-603a). The legend imposed on the Mohawk stock differed from that previously noted on the Atron certificates, and it was more restrictive. (52a, 62a, 78a, 79a).

The district court dismissed the portion of plaintiffs' complaint which was based upon this "free stock" deception. The opinion below is not clear as to the reason for dismissal. It says simply that there is a "complete failure of a proof" (942a), a conclusion which follows an extensive discussion of the oral misrepresentations alleged by plaintiffs. The court also discusses the misrepresentations which plaintiffs alleged were implicit in the proxy statement. As to both (oral misrepresentations and implicit written misrepresentations), the court found for defendants on the facts. (942a-943a). However, there remains the question of whether the proxy statement was misleading in failing to make an express statement on the subject -- namely, whether holders of restricted Atron stock would receive Mohawk stock which could be sold in the public markets. This the opinion does not discuss.

There is no "failure of proof" in this regard because the proxy statement is in evidence, and its failure to make any express statement regarding transfer restrictions is undisputed. Thus it must be assumed

that the district court found the omitted information to be immaterial.

The finding was erroneous.* A reasonable Atron shareholder would have found it important to know that approximately 65% of all Mohawk stock to be issued as a result of the merger would be restricted and not saleable in the public markets. This would have been particularly important to Atron shareholders who were going to receive restricted stock, but it also would have been important to those shareholders who were to receive saleable ("free") stock.

If a shareholder is to receive saleable stock then he need only evaluate the proposed merger in terms of the prospects of the corporation <u>being acquired</u> and the fairness of the exchange ratio. He need not be satisfied with the longer range prospects of the <u>acquiring corporation</u>, for he can sell the stock of the acquirer, and thus receive fair value for his stock in the acquired corporation. However, if a shareholder is to receive restricted stock he must be satisfied with the longer range prospects of the surviving corporation, for he will not be able to terminate his investment until some later date. In addition, in making this evaluation of longer run prospects he must know the details of the restrictions to be placed on his

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* Securities and Exchange Commission Release No. 5226 (1933 Act; also No. 9444, 1934 Act; copy annexed hereto as an exhibit) expresses the SEC's view that non-disclosure regarding transfer restrictions is a deceptive practice.

stock. The evaluation process would differ depending upon whether the restrictions would be removed (e.g., by registration with the SEC) in one or two months or one or two years.

In the instant case, holders of unrestricted Atron stock (less than 30% of the outstanding stock) knew they would receive saleable Mohawk stock. Yet even to these shareholders it would have been important to know what percentage of the Mohawk stock to be issued in the merger would be restricted, for they could expect some selling after the merger, and the potential impact of that selling on the market price would be determined in part by the amount of stock which was available to be sold.*

The importance of potential restrictions on transfer of Mohawk stock also is evidenced by the discussion which this subject received at the meeting in which the top officers of Atron and Mohawk agreed upon the merger. (305a-306a). Atron's president asked that freely saleable Mohawk stock be issued to all shareholders, and Mohawk's president stated that the matter would be considered by the lawyers.

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* To be material an undisclosed fact need not be potentially important to <u>every</u> shareholder. It is sufficient if it may be important to some. <u>Northway</u>, <u>supra</u>.

The May 26, 1971, letter from Mohawk to former Atron shareholders is additional evidence of the importance of the "free stock" subject. A separate, two-page communication devoted solely to the transfer restriction question, it was prepared and distributed by Mohawk less than four weeks after the merger. Indeed the information contained in the May 26 letter is the very information which should have been disclosed in the proxy statement.

The failure of the proxy statement to make any disclosure regarding restrictions on Mohawk stock to be issued in the merger was significant in another respect. Mohawk itself held the largest block of restricted Atron stock (195,000 shares, plus 16,500 shares in Mohawk's pension fund). One effect of the merger was to remove the transfer restrictions on that stock. In essence Mohawk issued to itself 48,750 shares of its own stock (in exchange for 195,000 shares of Atron) and thereby received immediate full value for its Atron holdings, which it could not otherwise have sold. This was an additional reason for the merger and should have been highlighted, particularly because Mohawk was the <u>only</u> holder of restricted Atron stock who received immediate, full value for its stock.

Defendants have argued that it was unnecessary to make any proxy statement disclosure concerning "free

stock" because plaintiffs should have known that they would receive Mohawk stock which was restricted. This argument is fallacious for several reasons.

First, on the day of the merger, Mr. Stoutenburg, the president of Atron, believed that the holders of restricted Atron stock (with the exception of Atron officers) would receive saleable Mohawk stock as a result of the merger. (308a-309a; 941a-942a). If the president of the company being acquired, having at his disposal the lawyers who had prepared the proxy statement, did not know that the Mohawk stock would be restricted the plaintiffs cannot be charged with such knowledge.

Second, prior to the merger Atron officers who held Atron stock were required to sign statements acknowledging that they would not receive saleable Mohawk stock in the merger. (308a-310a; 554a (last sentence)). No commitments of this kind were demanded of any other Atron shareholders. This evidences the lawyers' expectation that only Atron officers would receive restricted Mohawk stock. Also, the proxy statement reference to the necessity for these "commitments" from Atron officers implied that absent such a commitment the Mohawk stock would be unrestricted.

Third, Mohawk had the power to issue freely saleable stock to all Atron shareholders simply by filing a registration statement with the SEC, to be effective on the day

of the merger. This arrangement is not uncommon; e.g., Republic Technology, supra, at 542-543. In the instant case plaintiffs could not know that a registration statement was not being filed unless they were so informed by Mohawk. The proxy statement is silent in this regard.

Fourth, this was a matter of some complexity, as evidenced by the May 26, 1971, letter (601a), the vehicle by which Mohawk finally disclosed the facts concerning restrictions on its stock. Plaintiffs cannot be charged with knowledge of these highly technical matters.

For these and other reasons, it cannot be concluded that plaintiffs should have known of the restrictions which would be placed on their Mohawk stock. In no event could they have known that the legend restrictions to be placed upon their Mohawk stock would be more limiting than the legend on their Atron certificates.*

If the holders of restricted Atron stock so much as suspected that the Mohawk stock to be issued to them in the merger would be restricted the merger could not have been approved. Every holder of Atron restricted stock

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* The validity of this change in the legend is not in issue here. It is mentioned only as further indication that absent a proxy statement discussion of the subject Atron shareholders could not have known all of the ramifications of the merger as it pertained to the restrictions on their stock.

(representing approximately 400,000 shares, even excluding Atron officers and Mohawk) would have dissented, demanded appraisal, and received cash. Even shareholders who believed Mohawk to be the best available investment would have dissented, because with the cash to be received from the appraisal they could purchase Mohawk stock in the open market and thereby obtain unrestricted stock. No holder of restricted Atron stock would have voted "yes" and settled for restricted Mohawk stock when by dissenting the restriction could be totally removed. This obvious proposition explains the silence of the proxy statement on the subject of stock transfer restrictions. Not until after the merger, namely, on May 26, 1971, could Mohawk afford to reveal its intention to restrict transfer of some 65% of the stock being issued in the merger.

CONCLUSION

The district court was correct in finding the "accounting change" deceptions material. The district court also was correct in adopting the Chasins type rescissional damage approach, although it unduly restricted the amount of the award by not accepting the April 30, 1971, stock values and by imposing a duty of mitigation.

The district court erred in barring recovery by ITNR. Voting is not a prerequisite to maintenance of an action under §14(a) of the 1934 Act.

The district court also erred in dismissing the "free stock" deception claim.

The judgment should be affirmed as to all plaintiffs except ITNR, as to which it should be reversed. The damage award should be increased.

Respectfully submitted,

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Attorneys for plaintiffs

OF COUNSEL:

Michael C. Devine

FOR RELEASE January 10, 1972

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549

SECURITIES ACT OF 1933
Release No. 5226
SECURITIES EXCHANGE ACT OF 1934
Release No. 9444

APPLICABILITY OF ANTI-FRAUD PROVISIONS OF SECURITIES ACTS TO CERTAIN ACTS AND PRACTICES IN CONNECTION WITH OFFERING AND SALE OF SECURITIES IN NON PUBLIC OFFERINGS

The Securities and Exchange Commission today called attention to the applicability of the anti-fraud provisions of the securities acts to certain acts and practices in connection with the offering and sale of unregistered securities in transactions not involving any public offering--so called "private offerings". Such transactions are exempt from registration under Section 4(2) of the Securities Act of 1933 but such exemption does not apply to a public resale of the securities by the purchaser. The Commission is particularly concerned about the position in which the purchasers of securities in such transactions may find themselves when they later desire to resell the securities.

Section 17(a) of the Securities Act of 1933 makes it unlawful in connection with the offer or sale of a security, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder makes it unlawful in connection with the purchase or sale of a security, to make misleading statements or to omit the disclosure of material facts and prohibits other fraudulent or deceptive acts or practices. In the opinion of the Commission, these provisions are violated when an issuer, a person in a control relationship with an issuer, or any other person, in connection with the private placement of securities, fails to inform the purchaser fully as to the circumstances under which he is required to take and hold the securities.

The Commission regards it as a deceptive act or practice for an issuer, a control person, or any other person to sell unregistered securities in a private transaction without fully informing the purchaser as to the applicable limitations upon the resale of the securities by the purchaser. The seller should inform the purchaser that the securities are unregistered and must be held indefinitely unless they are subsequently registered under the Securities Act of 1933 or an exemption from such registration is available. It should be pointed out that any routine sales of securities made in reliance upon Rule 144 can be made only in limited amounts in accordance with the terms and conditions of that rule and that in the case of securities to which that rule is not applicable compliance with Regulation A or some other disclosure exemption will be required.

If at the time a private sale of securities is made it is represented to the purchaser that an attempt will be made to register the securities at some future date or that compliance with Regulation A or some other exemption will be effected, the purchaser should be informed specifically as to the time when and the circumstances under which such attempt to register will be made or compliance with such exemption will be effected. If the issuer is under no obligation to register the securities or to comply with any such exemption, that fact should be made clear to the purchaser. The purchaser should also be informed as to whether the seller will supply the purchaser with any information necessary to enable the latter to make routine sales of the securities under Rule 144.

The Commission strongly recommends the use of restrictive legends on stock certificates and stop-transfer instructions to transfer agents as a means of preventing the illegal sale of privately placed securities (see Securities Act Release 5121), and the purchaser should be informed prior to being committed to purchase the securities whether such a legend will be placed on the certificate or such instructions will be issued.

By the Commission.

Ronald F. Hunt
Secretary

SERVICE OF 2 COPIES OF THE WITHIN

Appellees Brief

IS HEREBY ADMITTED.

DATED: 7/2/75

Attorney for

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July 2 1975

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